Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-1641-99
[redacted]

date: June 25, 1999

to: Chief, Examination Division, [redacted]
Attn: [redacted]

from: District Counsel, [redacted]

subject: [redacted]--**Request for Advice**

DISCLOSURE STATEMENT

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This memorandum is in response to your request for District Counsel advice. Attached are the related work papers.

ISSUES

1. Whether the method of accounting for the sales revenue of [redacted], a subsidiary of [redacted] (hereinafter "[redacted]"), related to the selling of software and related services, clearly reflects income under I.R.C. § 446?

2. Whether the taxpayer was required to seek the

Commissioner's approval for the adoption of [redacted] current method of accounting?

3. Whether the principal purpose of [redacted] in placing the assets of [redacted] in a subsidiary was to avail [redacted] of an accounting method unavailable without the consent of the Commissioner?

CONCLUSIONS

1. [redacted] method of accounting does not clearly reflect income under I.R.C. § 446.

2. [redacted] was required to seek the Commissioner's approval to change its method of accounting.

3. There is no evidence that [redacted]'s principal purpose in placing the assets of [redacted] into a newly formed subsidiary was to avail [redacted] of an accounting method unavailable without the consent of the Commissioner.

FACTS

Prior to [redacted] and [redacted] were two divisions of [redacted]. Separate accounting systems were maintained, but only a single entity return was filed. In January [redacted] placed the [redacted] and [redacted] divisions into two wholly owned subsidiaries in an I.R.C. § 351 transaction. The subsidiaries are included in [redacted]'s consolidated return.

[redacted] develops the software and licenses it to [redacted]. [redacted] markets, sells and licenses software and provides services, e.g., installation assistance, custom design, computer programming and consulting services. [redacted] uses two contract forms depending on whether it is providing only services or is also licensing software. All the contracts are typically of less than a 12 month duration.

The services contract, the [redacted] (hereinafter '[redacted]'), covers both general consulting services and specific consulting services. According to the terms of the [redacted], general consulting services are billed on a time and materials basis while specific consulting services, generally the larger contracts, are billed per a particular engagement letter, scope of work or exhibit. Generally, however, the terms of the specific consulting services are substantially similar to those for the general consulting services.

In time and material contracts, the customer agrees to pay [redacted] for the actual hours expended and additional costs incurred "upon request of customer." This latter arrangement also appears to be billed on a time and material basis. Both categories are referred to by the taxpayer as "project based" because the client desires a particular result.

Where software licensing is involved, [redacted] uses the standard [redacted] (hereinafter "[redacted]"). The payment terms of the [redacted] provide that the customer pays [redacted] percent of the license fee upon executing of the [redacted] (and any attachment thereto) and the remaining [redacted] percent within thirty days after the delivery of the product. One attachment to the [redacted] is for services associated with the licensing of the software. The payment terms for these services are identical to those of the [redacted], in result, billing on a time and materials basis (see discussion above).

Notwithstanding the above-described differences in billing methods, all contracts sampled were billed under [redacted] policy as follows: [redacted] invoices the customer monthly based on work performed from the 16th of the previous month to the 15th of the invoice month. To allow time to accumulate the needed information, the bill is generally dated around the end of the month and mailed shortly after the 1st of the following month.

Other Contract Terms

Both the [redacted] and the [redacted] provide that uncontested payments are due within thirty days of the invoice date, that the customer has thirty days to contest payment and that payments are nonrefundable except as provided elsewhere in the contracts. Both contracts provide a warranty for, inter alia, services and developed software. Specifically, the contracts provide that the services supplied "shall be performed in a professional and workmanlike manner," and that:

> "the unmodified Developed Software shall operate in all material respects in accordance with the written, mutually agreed upon specifications for such Developed Software from the date of completion of such Developed Software for a period of ninety (90)days. However [redacted] shall have no responsibility for problems in the Developed Software caused by alterations or modifications made by Customer or a third party, or arising our of the malfunction of Customer's equipment or other software

products not supplied by [redacted]."

The [redacted] also warrants that the licensed products will perform as specified for six months following the date of delivery to the site.

The "Exclusive Remedies" section of the [redacted] provides:

> (A) Services: Customer is entitled to re-performance of the Services, or if [Solutions] cannot perform the Services as warranted, Customer is entitled to a refund of the fees paid to [redacted] for the Services subject to the breach.
> (B) Developed Software: [redacted] agrees to correct, at no charge, all material nonconformances in the Developed Software of which [redacted] receives notification during the ninety (90) day warranty period. If a material nonconformance is incapable of correction, it shall be considered a breach of warranty and Customer shall be entitled to return the nonconforming Developed Software and receive a refund of fees paid for the nonconforming Developed Software.

The [redacted] contains identical language and additionally provides that the customer has six months following delivery of licensed products to verify that they operate as promised and must provide written notice of any material nonconformance within this six month. [redacted] then has six months from receipt of such notice to provide a mutually acceptable plan to correct the defect. If no such plan can be agreed to, the customer may terminate the contract and will receive a refund of the license fees.

Historically, [redacted] has been on the overall accrual method and accounted for consulting and implementation services income for both its financial reports and tax in accordance with [redacted], i.e. when performed. Related expenses are deducted currently. For financial accounting, income is recognized as services are performed, less a reserve for bad debts. In practice, this means accrual was around the 15th of the month (when billing occurred around the 30th). For tax purposes prior to the formation of the subsidiaries and for their first year, the tax accounting followed book except the reserve was backed out. But commencing in [redacted], [redacted], through an M-1 entry reducing book income by $[redacted], did not recognize its final [redacted] weeks of consulting and implementation revenue. This meant that income accrual did

not occur until 30 days after billing.

DISCUSSION

ISSUE 1

Law

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. See also § 1.446-1(a)(1).

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. See also §§ 1.446-1(a)(2) and 1.446-1(c)(1)(C).

Treas. Reg. § 1.446-1(a)(2) provides that a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

Treas. Reg. § 1.446-1(c)(1)(C) provides that the method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the regulations.

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. See also Treas. Reg. § 1.451-1(a).

Section 1.451-1(a) also provides that, under an accrual method of accounting, if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made.

Section 451 and the regulations thereunder provide rules for determining when items are properly includible in a taxpayer's gross income. For a taxpayer using an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (the "all-events test"). Treas. Reg. § 1.451-1(a). All the events that fix the right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127; Rev. Rul. 83-106, 1983-2 C.B. 77; Rev. Rul. 81-176, 1981-2 C.B. 112; Rev. Rul. 80-308, 1980-2 C.B. 162; Rev. Rul. 79-195, 1979-1 C.B. 177.

Section 461(a) provides that the amount of any deduction or credit allowed by Subtitle A shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Treas. Reg. § 1.461-1(a)(2) provides that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. See also Treas. Reg. § 1.446-1(c)(1)(ii)(A). If the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance occurs as the taxpayer incurs costs in connection with the satisfaction of the liability. Treas. Reg. § 1.461-4(d)(4)(i).

The Internal Revenue Service has broad authority in determining whether an accounting method used by a taxpayer clearly reflects income. See, e.g., United States v. Catto, 384 U.S. 102, 114 (1966); Commissioner v. Hansen, 360 U.S. 446, 467 (1959); Brown v. Helvering, 291 U.S. 193, 203 (1934). That authority is limited, however, in that the Service cannot require a taxpayer to change from an accounting method that clearly reflects income to an alternate method that more clearly reflects income. See, e.g., Estate of Ratliff v. Commissioner, 101 T.C. 276, 281 (1993); Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 31 (1988); Molsen v. Commissioner, 85 T.C. 485, 498 (1985). The issue of whether a taxpayer's method of accounting clearly reflects income is a question of fact to be determined on a case-by-case basis. See, e.g., Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. 367, 371 (1995); Pacific Enterprises v. Commissioner, 101 T.C. 1, 13 (1993). In general, however, a

method of accounting that is consistent with the Code or the regulations is presumed to clearly reflect income.

Analysis

[redacted]'s argument is a nonsense distortion of the all events test. Specifically, [redacted] claims that [redacted] delay in accrual of service income for six weeks from the completion of performance which will be billed approximately fifteen days later is justified because until the six weeks have passed, all events fixing the right to receive the income have not occurred. [redacted] states (confusingly) that the second test of the all events test, that the amounts can be determined with reasonable accuracy, is not at issue. But rather, [redacted] argues, quite novelly, that the first prong of the all events test is not met until both performance takes place and payment is due. [redacted] argues that in [redacted] situation, neither of these tests is met until thirty days after billing.

According to [redacted], the performance at issue, i.e., that which will be billed in the next fifteen days, is not complete because, first, in a project based contract, such as are [redacted], performance is not complete until all services under the contract are performed, i.e., the project is complete. In such case, full performance does not occur until the last step is complete.

The second requirement in [redacted]'s version of the first prong of the all events test is that payment must be due. [redacted] argues that this point is only reached when payment is unconditionally payable. This stage is not reached until the earlier of when the client has reviewed the bill and paid it or thirty days have passed from the billing date. Because the customer has thirty days to pay the bill and the customer has thirty days to contest, payment is not unconditionally payable for thirty days from billing. [redacted] cannot force payment before thirty days and a contested claim is not accruable.

Further, although [redacted] initially states that the second prong of the all events test is not at issue, it states that because of the refund guarantee, there is no unconditional right to payment prior to the billing date. Query. When was the billing date ever at issue as the accruable event?

[redacted] cannot prevail on any of its theories. First, [redacted]'s "project based" argument appears to be an attempt to put [redacted] on a completed contract basis of accounting. But [redacted] is not eligible for the long-term contract method of accounting. The long term contract method of accounting is not an available method for service contracts. I.R.C. § 460(f)(1). Further, the method of

long-term contract accounting which [redacted] describes as appropriate for [redacted] is a form of the completed contract method where no income is recognized until the completion of the contract. Generally, this method is not available as a method of accounting since the enactment of I.R.C. § 460. I.R.C. § 460(a). Consequently, this "project based" argument does not justify [redacted] six week delay in accrual.

Second, [redacted]'s version of the all events test is not supported by any authority. The definitive statement of the all events test occurred in Schlude v. Commissioner, 372 U.S. 128 (1963). In that case the Court said that all the events that fix the right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128 (1963). These alternative tests are each individual; no combination of any two are required. In [redacted] case, it is a reasonable assumption that the vast majority of customers represented by the $[redacted] in billings at issue will not contest the services or the billed amounts. For this group, the all events test was met at the latest on the 15th day of the month prior to the billing. For it is at this point that [redacted] has completed the performance justifying the billing under the particular contracts.

The fact that the payment is not considered delinquent until thirty days after billing does not delay accrual of income for federal income tax purposes. In [redacted] case, accrual is upon performance, the earliest event under Schlude. The specific language in the contract that the "[c]ustomer agrees to pay for all uncontested amounts within thirty days" does not affect the correct accrual date. The taxpayer has merely allowed a period for such payment. The fact that collection of accounts receivable may be slowed by the contract provisions doesn't justify deferral under the accrual method.

Even the prospect of a known substantial delay in payment is not enough to prevent accrual. Koehring v. United States, 421 F.2d 415 (Ct. Cl. 1970). In that case, an accrual basis taxpayer was required to include in its 1953 and 1954 income royalties not received until 1956. The court said that at the time the receivables accrued, the taxpayer had a reasonable expectancy of payment. Id. at 721-722. So also does [redacted] have a reasonable expectancy of payment at the completion of its performance. Also by the Koehring measure, [redacted] six week delay from the completion of the performance subject to billing could not be considered substantial.

Even in those cases where there are known specific

circumstances which will postpone payment, deferral of accrual is not allowed. Harmont Plaza, Inc. v. Commissioner, 64 T.C. 632 (1975), aff'd by order, 549 F.2d 414 (6th Cir. 1977); cert. denied, 434 U.S. 955 (1977). In Harmont Plaza, the taxpayer was required to accrue rental or the indemnification for it even though the payment was conditional upon the indemnitor's realizing a positive cash flow and having cash in excess of priority obligations. See also other cases cited in Tax Management Portfolio, No. 570, at note 1036. By comparison with the cases of known difficulties to collection, [redacted] has presented no evidence indicating knowledge of any specific circumstances which would delay accrual at the time it completed its performance.

Further, in [redacted] case, at the time of the completion of the performance subject to billing under the contract terms, there was no specific contingency or condition precedent to [redacted]'s receipt of payment which could be interpreted as interfering with a reasonable expectancy of payment. In determining whether a contingency in collection is sufficient to defer accrual from the billing date, the question is whether it is reasonable to expect that collection will not occur or whether there is a reasonable doubt as to the ultimate collection of the amount due. Jones Lumber v. Commissioner, 404 F.2d 764 (6th Cir. 1968). See also additional cases in Tax Management Portfolio, No. 570, at note 1034. The mere warranting of its services, a normal business practice, cannot be interpreted in taxpayer's case, a healthy and viable business, as creating contingencies other than highly remote ones.

Further, there is no explicit condition precedent to the collection of [redacted]'s receivables to warrant nonaccrual. See, e.g., Union Pacific Railroad v. Commissioner, 14 T.C. 401, 405-406, 409-411 (1950). Thus, there is no impediment to payment, no specific condition precedent to collection, presumably no expectation of nonpayment of the $[redacted] in accounts receivable for the services routinely provided by [redacted]. As such, they cannot justify a deferral of $[redacted] in receivables for thirty days.

The incorrectness in [redacted]'s argument is also evident from the cases it relies on for support for its version of the all events test. [redacted] cites Decision, Inc. v Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2, for the proposition that there are no case holdings "that income accrued upon part performance of a contract prior to an agreed billing or payment date." This case is no authority for the proposition that there is no accrual until a contract is completed. In Decision, advertising contracts received in 1963 were not, by contract, to be billed

and payable until 1964. But in Decision, there had been no performance in 1963 either. The advertising would not be run until 1964. Therefore the court held accrual of income was not required.

That case is clearly distinguishable from the instant situation where the performance had occurred in [redacted], and there was no contractual provision stating that there was no liability until billing. Further, the performance will be billed in two weeks from the completion of the performance, and such a delay as there is in billing is only an administrative one.

The taxpayer cites the cases of Thompson v. Commissioner, 489 F.2d 288 (4th Cir. 1973); Cox v. Commissioner, 43 T.C. 448 (1965), acq. 1965-2 C.B. 4; and Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2 for the proposition that no income need be accrued until it is due. In [redacted] case, so argues [redacted], that would only be thirty days after billing. First, Thompson is not apposite to [redacted] case. In Thompson, the taxpayer was not required to accrue income for services performed where the right to payment under the contract was limited to work delivered to the job site. The Fourth Circuit Court of Appeals, overturing the Tax Court (T.C. Memo. 1971-321), found that there was a condition precedent to payment: the delivery of the goods to the job site. This delivery had not occurred prior to the termination of the contract by the United States Government. Thus, there was a condition precedent to receipt of payment which had not been met. In the instant case, in contrast, there is no defined condition precedent. Neither [redacted] allowance of 30 days to pay the invoice nor its general warranties rise to this level. Further, the circuit court found in Thompson that the cumulative effect of the terms of the contract and the actual events created sufficient uncertainties and that the amount could not be calculated with reasonable accuracy. Again, this is not the instant taxpayer's case. Lastly, there was a specific customer collection at issue in Thompson; not so in [redacted] case.

[redacted] cites Cox for the proposition that the terms of the bill itself may determine when payment is due. Again, the case does not support [redacted]'s position. The Cox court did hold that in one instance, the unbilled fees did not have to be accrued where they were not payable under the contract until billed. But, very importantly, they were not accruable only where they were not "supported by services rendered." So in Cox, then, had there been performance, it alone would have supported accrual. As discussed above, Decision, is also a case where there had not yet been performance and thus accrual was not required where the contract provided for billing and payment in the next year. In

[redacted] case with respect to the billings at issue, there has been performance.

[redacted] cites cases supporting the proposition that contested claims are not accruable. Brutsche v. Commissioner, 65 T.C. 1034 (1976), rem'd on another issue, 585 F.2d 436 (10th Cir. 1978); Swastika Oil and Gas Co. v. Commissioner, 123 F.2d 382 (6th Cir. 1941), cert. denied, 317 U.S. 639 (1942). These cases are inapposite, however, for there is no evidence of specific contested claims in [redacted] case; there is only a general possibility that there may be some disputed bills.

In Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988), another case cited by the taxpayer, there is no issue of any uncertainty affecting the likelihood of payment for performance which will be billed within two weeks. Rather, in Hallmark, there is only a question of the sales contract providing that although Valentine merchandise was delivered prior to January 1, the title and risk of loss did not pass until January 1. That is, the actual sale of goods did not occur until January 1. Thus, by contract, all events had not occurred on delivery of the good. The passage of title and risk of loss, which fixed Hallmark's right to the income, did not occur until January 1. [redacted] case did not involve the sale of goods.

In Priv. Ltr. Rul. 98-23-003 (June 5, 1998), the facts again involved goods, specifically developed film. The issue involved the proper method for a retail store to accrue income in connection with its film processing. The film prints are produced primarily by the taxpayer-owned photo labs, but also by unrelated labs. The taxpayer treated the customer acceptance and payment of the processed film as a sale of merchandise, accounting for the finished prints held prior to customer pickup as inventory. The taxpayer also had a well advertised warranty on the photo prints that the customers were not required to pay for the prints unless they found them satisfactory. The ruling concluded that because the taxpayer could not compel the customers to pay for the prints, i.e., to buy them, the taxpayer was not required to accrue income until the customers chose to pay for the prints, i.e., at the point of sale.

This ruling, based on its particular facts, does not support [redacted] case because it involved the sale of merchandise requiring delivery and the existence of inventories. The timing of permitted accrual in the ruling was consistent with that of the taxpayers engaged in manufacturing to account for sales of their product using inventories, inter alia, when the goods are accepted. [redacted], in contrast, does not use inventory accounting. Further, it should also be noted that because of the

use of inventories, the associated costs capitalized into inventory were not deducted until the sales occurred. Lastly, while [redacted] customers may dispute the charges for the services, the services have been provided. In the ruling, the "sale" had not yet occurred.

With respect to the second prong of the "all events test,", the [redacted] may be claiming that because of its warranties, the amount owing cannot be determined with reasonable accuracy at the time of billing. Thus, there should be no accrual. As support, [redacted] also cites several authorities where, in accordance with the explicit terms of contracts, a governmental entity retained certain amounts of the billed invoices to guarantee satisfaction. In these cases, the taxpayer was not required to accrue the retained income until the condition precedent for the release of the retainage fees occurred. Specifically, [redacted] cites Rev. Rul. 69-314, 1969-1 C.B. 139, United States v. Harmon, 205 F.2d 919 (10th Cir. 1953); and Gar Wood Industries, Inc. v. United States, 437 F.2d 558 (6th Cir. 1971).

These authorities are all distinguishable from the taxpayer's case. [redacted] cites Rev. Rul. 69-314, 1969-1 C.B. 139, for the proposition that performance takes place only as the performance is complete, not as the activity is performed. In the ruling, the government withheld a percentage retainage fee pending delivery of the merchandise. The ruling permitted no accrual until such merchandise was delivered. United States v. Harmon, 205 F.2d 919 (10th Cir. 1953); Gar Wood Industries, Inc. v. United States, 437 F.2d 558 (6th Cir. 1971), also involve actual retainages on the part of the customers. In Harmon, the thirty percent retainage was not due until a final audit was made by the government. Similarly, in Gar Wood, the business had no right to fees withheld under a government contract until a final decision was rendered by the Armed Services Board of Contract Appeal. In [redacted] case, there are no contractual retainages, or anything approaching such a situation. Hence, the taxpayer cannot rely on these cases.

[redacted] presents no evidence, authority or legal theory to justify nonaccrual at this midmonth time. Rather, [redacted] is relying on a generalized statistical probability that there will be some disputes over services and billed amounts. By deferring accrual on this basis, [redacted] is attempting to create for tax purposes what it accomplished for financial accounting purposes with a collection reserve. This is not permissible for tax purposes. Tax accounting and financial accounting do not have the same function. As the Court has noted in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542 (1979) and in United States v. Hughes Properties, Inc. 476 U.S. 593, 603 (1986), the principal

purpose of tax accounting is the accurate reflection of the taxpayer's income, a concept which does not necessarily correlate with the goal of financial accounting with its foundation of financial conservatism.

In light of the above, petitioner is required under the "all events test" to accrue the billed amounts when performance is complete and billable under the terms of the contract.

ISSUE 2

Law

Section 446(e) and Treas. Reg. § 1.446-1(e) provide that a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Treas. Reg. § 1.446-1(e)(2)(i) provides that such consent must be secured whether or not such method is proper. Treas. Reg. § 1.446-1(e)(1) provides that a taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income.

Section 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting includes a change in the overall plan of accounting for gross income or a change in the treatment of any material item such in such overall plan. A material item is any item which involves the proper time for the inclusion of the item in income. The regulation further provides that although a method of accounting may exist without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment.

Rev. Rul. 90-38, 1990-1 C.B. 57, provides that normally, a method of accounting must be used for two or more consecutive tax returns to be considered "consistent treatment. The ruling, however, goes on to state that if the taxpayer treats an item properly in the first return that reflect the item, it is not necessary to treat the item consistently in two or more consecutive tax returns before the taxpayer has adopted a method of accounting. After a method of accounting for an item has been made on a return, it may not be changed after the time for filing the return has expired. See Pacific National Co. v. Welch, 304 U.S. 191 (1938); Lord v. United States, 296 F.2d 333 (9th Cir. 1961); National Western Life Insurance Co. v. Commissioner, 54 T.C. 33 (1970).

Analysis

In the first year of its operation as a subsidiary of [redacted] in [redacted], [redacted] continued to use the method of accounting it had while a division of [redacted], i.e., accrual of income on the completion of performance which was billable under the particular customer's contract and which amount was actually billed two weeks later. In the second year of its independent operation as a subsidiary of [redacted] in [redacted], [redacted] changed its method to that discussed under Issue 1, i.e., deferring accrual for six weeks following the completion of performance. Because [redacted], as a new entity, did not use the prior method more than one year, [redacted] claims that [redacted] had not adopted a method of accounting, citing Rev. Rul. 90-38, 1990-1 C.B. 57, and would therefore not be required to obtain the consent of the Commissioner to change to the method discussed under Issue 1.

This position is not correct. [redacted] method of accounting for the timing of the recognition of income in its first year of operation as a subsidiary was a correct one. This is because the timing of the accrual of income was the correct timing. Consequently, it was not necessary for [redacted] to treat the timing of the recognition of its earned income consistently in two or more consecutive tax returns before it had adopted a method of accounting. Rev. Rul 90-38, 1990-1 C.B. 57.

As [redacted] had adopted a method of accounting in [redacted], it was required to seek the consent of the Commissioner before changing it in [redacted]. Treas. Reg. § 1.446-1(e)(2)(i); Pacific National Co. v. Welch, 304 U.S. 191 (1938); Lord v. United States, 296 F.2d 333 (9th Cir. 1961); National Western Life Insurance Co. v. Commissioner, 54 T.C. 33 (1970).

ISSUE 3

Treas. Reg. § 1.1502-17(c) provides that if one member of a consolidated group (B) directly or indirectly acquires an activity of another member (S) with the principal purpose to avail the group of an accounting method that would be unavailable (or would be unavailable without securing consent from the Commissioner) if S and B were treated as divisions of a single corporation, B must use the accounting method for the acquired activity determined as if B had acquired S in a transaction to which § 381 applied or must secure consent from the Commissioner to use a different method.

We do not believe that the provisions of Treas. Reg. § 1.1502-17(c) are application to the instant situation. As [redacted] did not adopt the impermissible accounting method until

its second year of operation, the government would have a difficult time proving that the adoption of such a system was the principal purpose of the creation of [redacted] as a subsidiary of [redacted]. Consequently, we do not recommend pursuing this issue.

We are forwarding this advisory to you at the same time that we are sending it to the National Office for a post review. Normally, this post review is a ten day review. Consequently, we request that you not take any action on the basis of this advice until we have received the results of the National Office review.

If you have any questions on these matters, please do not hesitate to contact us.

[redacted]
District Counsel

By: _____
[redacted]
Attorney

Attachments